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Transaction Privilege Tax Guiding Principles

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1. What it is

The transaction privilege tax (TPT), as explained on the Department of Revenue's website "is a tax on the privilege to do business in Arizona. Many refer to it as a "sales tax." Although it operates like sales taxes in other states for most consumers, it is slightly different. For example, transactions involving the federal government and other sovereign nations are not subject to a sales tax, but because the responsibility for the TPT falls on the vendor, transactions with the federal government or other sovereign nations are subject to the TPT.

Currently, Arizona has over 100 exemptions from TPT. These exemptions range from food and medical supplies, most services, rodeo animals, hotel soaps, to health club memberships and a variety of other exemptions. It is our proposal that Arizona adopt a set of guiding principles that would allow Arizona policy-makers a coherent framework and decision matrix for granting or denying tax exemptions. Guiding principles, if regularly and rigorously applied, would enhance the rationality of Arizona's TPT.

Recommended Guiding Principles:

Broad base and low rate: basic economic theory indicates that the best tax system has as broad a base and as low a rate as possible. This makes the tax system more robust and better able to withstand economic swings. When the base is narrow, even minor fluctuations in relatively few industries can have a significant impact on state revenues. When the base is as broad as possible, weaknesses in one industry can more easily be offset by gains in others. A broader base also allows for a lower rate. This principle suggests that, when in doubt, the default option is to subject a good or service to the TPT.

Economic efficiency: From an economic perspective, business or consumer behavior should not be distorted by the tax code. (There may be compelling public policy exceptions to this.) This principle also dictates the same good or service should not be taxed multiple times (e.g. no double taxation).

Ease of Administration: Taxes should be easy for the consumer to pay, the vendor to collect and the State to monitor and enforce. If these standards cannot be met, or compliance costs are higher than the revenue raised from the tax, then an item or service should be exempt from the TPT.

Basic needs: The TPT is inherently regressive (meaning that lower income families pay a higher proportion of their income on such taxes than more affluent households). Since low and moderate-income families often struggle to afford the basics (see Appendix A), taxing necessities would make it only more difficult for these families to make ends meet. Therefore, goods and services that are linked to basic necessities, such as food and medicine, while a major source of TPT revenue for many cities and towns, should remain exempt from the state TPT. [1]

Accountability: Exemptions should contain a clear and timely purpose, incorporate accountability measures, and be subject to regular review. Exemptions that are created to achieve a policy goal (e.g., job creation) should be regularly evaluated to be sure that goal is being met. If the goal is not met, the exemption should be eliminated. Exemptions should also be regularly reviewed to make sure that the original goal is still a valid objective for the state.

2. How it would be administered

The Department of Revenue would continue to monitor and enforce collection of all TPT at the state level. The guiding principles could be written in statute with a requirement that any proposed tax exemption be analyzed by JLBC and DOR for whether or not it meets each guiding principle criterion. This analysis would have to be completed in written form and available for comment and review at least 2 business days before the first hearing of a bill (or an amendment to a bill) to add new exemptions.

Applying these proposed guiding principles would imply the following treatment of existing exemptions:

Double taxation: exemption continues due to efficiency principle
Double taxation is economically inefficient and distorts consumer behavior and decisions.

Business to business services: exemption continues due to efficiency principle
It is economically inefficient and distorts business decisions to tax business to business service transactions. For example, a company may choose to use their own employee to provide a service even if an independent firm could provide that service more efficiently. (Michael Mazerov, *Expanding Sales Taxation of Services*: *Options and Issues,* Center on Budget and Policy Priorities, June 2003, www.cbpp.org/3-24-03sfp.htm)

Professional services: exemption continues due to efficiency principle or basic needs
Most professional services are either business to business services (such as accounting, employee leasing, and engineering) or serve basic needs (such as physicians and nurses).

Personal services: exemption ends due to broad base principle
The broad base, low rate principle dictates that, in the absence of compelling evidence otherwise, goods *and services* should be taxed. Nationally, the share of personal consumption of services increased from 26% in 1960 to 42% in 1991. (NCSL and NGA,

[1] PLEASE NOTE: The League of Arizona Cities and Towns believes that the "Broad base and low rate" principle outweighs the principle of exempting basics from taxation. It should be noted that food purchased with food stamps is exempt from state and local sales tax by federal law.

Financing State Government in the 1990s, December 1993). Broadening the TPT base to include personal services will help move the TPT tax base into the 21st Century and reduce year-to-year volatility in sales tax collections. (Michael Mazerov, *Expanding Sales Taxation of Services: Options and Issues*, Center on Budget and Policy Priorities, June 2003, www.cbpp.org/3-24-03sfp.htm)

Other Services: exemption ends due to broad base principle
The broad base, low rate principle dictates that, in the absence of compelling evidence otherwise, goods *and services* should be taxed. Also, the ease of administration principle should apply.

Environmental products: exemption ends due to broad base principle
The broad base, low rate principle dictates that, in the absence of compelling evidence otherwise, goods *and services* should be taxed. If an evaluation shows that a particular exemption is effective at its given goal (e.g., improving air quality), then that exemption should continue. However, it should be subject to evaluation and monitoring to ensure that it is working and is relevant to current state objectives. Also, the ease of administration principle should apply.

Economic development: exemption ends due to broad base principle
The broad base, low rate principle dictates that, in the absence of compelling evidence otherwise, goods *and services* should be taxed. If an evaluation shows that a particular exemption is effective at its given goal, then that exemption should continue. Again, all exemptions should be subject to evaluation and monitoring to ensure that they are working and are relevant to current state objectives. Also, the ease of administration principle should apply.

In assessing economic development in particular, a review of 33 separate economic studies found business taxes have only between a 0% and 2% association with investment and employment. (Michael Wasylenko, "Taxation and Economic Development: The State of the Economic Literature," *New England Economic Review*, March/April 1997, p. 44) This is understandable since state and local taxes are less than 2% of operating income for the typical business. (Tom Rex, *Public Finance*, ASU Center for Business Research, January 2003).

Nonprofits: exemptions continues due to ease of administration and basic needs principles.
Exemptions for non-profits are based on the vendor or purchaser rather than the good or service. Simplicity dictates that all entities with the same federal tax status (e.g. Internal Revenue Code Section 501(c)(3)) be treated in the same manner. Since many of the non-profit exemptions are aimed at qualifying hospitals or other providers of basic needs, non-profits should remain tax-exempt. It would be cumbersome for the agency and state to "prove" that a given agency helped meet basic needs. Also, many non-profits provide multiple services (some of which may be classified as basic needs and some of which may not) and it would be administratively difficult to subject various activities or purchases of the same group to different tax treatment.

Basic Needs: exemption continues due to basic needs principle
The TPT is inherently regressive (meaning that lower income families pay a higher proportion of their income on such taxes than more affluent households). Since low and moderate-income families often struggle to afford the basics, taxing necessities would make it only more difficult for these families to make ends meet. Therefore, goods and services that are linked to basic necessities, such as food and medicine, should remain exempt from the state TPT.[2]

Other: exemption ends due to broad base principle
The broad base, low rate principle dictates that, in the absence of compelling evidence otherwise, goods *and services* should be taxed. If an evaluation shows that a particular exemption is effective at its given goal then that exemption should continue, subject to on-going monitoring and evaluation. Also, the ease of administration principle should apply.

3. Impact on existing revenue streams

Broadening the base alone would result in increased state TPT revenues of over $440 million for the state. (See section 6 for more information). This impact would be diminished if the rate were lowered.

Cities and counties may be affected by broadening the base. If the base is expanded and the rate kept at 5.6%, then counties and cities will get additional monies through the current revenue sharing system. However, in order for cities and counties to be affected by a broadening of the base, any new classifications would need to be assigned to the distribution base in state statute. If the base is expanded and the rate is lowered so that the proposal is revenue neutral, then cities and counties are less likely to be affected.

4. Cost

Some research suggests that expanding the sales tax base to services can simplify the process of administering and complying with the sales tax. When retailers sell both taxable goods and services as well as tax-exempt services, it can be difficult and costly for tax administrators and merchants alike to ensure the proper amount of taxes has been collected or remitted. If all of the sales are subject to taxation, accounting burdens lessen. However, it is important to recognize that as new vendors are brought into the system, administrative capacity could be strained. (Michael Mazerov, *Expanding Sales Taxation of Services: Options and Issues*, Center on Budget and Policy Priorities, June 2003, www.cbpp.org/3-24-03sfp.htm) DOR does not have an estimate on the agency cost of expanding the sales tax base.

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5. **Policy Considerations**

A. Equity

Taxing a broader base of goods and services increases horizontal equity because it increases the likelihood that taxpayers with an equal ability to pay will be treated in equal ways. One instance where this is particularly compelling is when providers of the same type of good or service are currently treated distinctly because of the manner in which the good or service is provided. An example of this is cable providers, which are currently taxed, and satellite television providers, which are currently exempt.

However, expanding the TPT base, without a decrease in the overall TPT rate, is low in vertical equity. In Arizona, low income families (those with incomes of less than $15,000 per year) pay more than two and half times as much of their income to TPT as more affluent households (those with incomes of $65,000 or more). (Institute on Taxation and Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States,* January 2003, www.itepnet.org) Increasing the tax burden of low income families will only add to the overall regressivity of Arizona's tax system. Vertical equity could be modestly improved (assuming higher income households buy more services) by lowering the overall TPT rate, and/or increasing the existing refundable tax credit for low-income families.

B. Economic Vitality

Most other states have a sales tax or TPT and most tax a wide array of goods and at least some services (See Appendix B). However, Arizona's sales tax rate is high to medium compared to other states (17 states have a higher state rate: Comparison of State and Local Retail Sales Tax, January 2003, Federation of Tax Administrators). Looking solely at competitor states, we are in the middle, with 5 states having sales tax rates of 6% or more. (See Appendix C)

If Arizona expanded the TPT tax base and lowered the rate, then our tax rate would likely be lower than most competitor states.

Also, many goods and services are provided to a local market. While a manicurist may not like to collect TPT from customers, it is unlikely the business -- with an established clientele base and reputation -- would relocate to another state just to avoid collecting TPT. Other examples of local markets include: interior design, automobile parking, most repair services, personal services, meals provided to restaurant employees, and certain entertainment events.

Finally, policy-makers should weigh the specifics involved in any given case. Arizona should seek to be competitive in quality of life issues as well as having a tax code in line with neighboring and competitor states. One of the major factors that contributes to high quality of life is a particular level of physical and social infrastructure that is expected by the citizens of Arizona. TPT is a major revenue source for this infrastructure, and changes to both the state and local level should be carefully considered.

C. Volatility

Arizona's TPT in general tracks changes in personal income. (Joint Legislative Budget Committee, www.azleg.state.az.us/jlbc/powerpt/powerpt8/sld001.htm) Broadening the base will further add to the stability of the income stream.

D. Ease of Administration
Mechanisms are already in place for collection and monitoring of the TPT. Some newly taxable businesses may need to set up procedures to collect the TPT. Other businesses (such as auto repair shops which charge a tax on parts but not services) will be able to streamline their collection.

6. Economic Impact
If the base were to be broadened according to these principles with no corresponding decrease in the TPT rate, more than an additional $440 million in state revenue would be raised. (Please see matrix prepared by Group 2 of the TPT subcommittee.) If the rate were lowered at the same time, the amount raised would, of course, be less.

7. Other
By applying uniform guiding principles to the maintenance and creation of tax exemptions, Arizona could become a national leader in the creation of a logical TPT or sales tax system designed to enhance stability and efficiency while protecting rational interests of the state. Our research revealed no other state that systematically applies a decision matrix of basic principles in the reviewing or granting of potential and/or existing state TPT or sales tax exemptions.

APPENDIX

Appendix A: Strengthening Families on Self-Sufficiency Standard
http://www.azchildren.org/caa/_mainpages/Publications/_sf_sss_.pdf
Appendix B: Tax treatment of selected services by other states (Camarot Report)
Appendix C: Sales tax rates of competitor states

Appendix C

Comparison of Sales Tax Rates of Competitor States

State	Sales Tax Rate
Oregon	No state sales tax
Colorado	2.9%
Georgia	4.0%
Utah	4.75%
New Mexico	5.0%
Arizona	**5.6%**
California	6.0%
Florida	6.0%
Texas	6.25%
Washington	6.5%

Source: http://www.taxadmin.org/fta/rate/sl_sales.pdf